[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS AND OTHER ESTATE TAX MATTERS RELATING TO THE SECTION 6166 TECHNICAL REVISION ACT OF 1982 (S. 2479); THE TAX TREATMENT OF CERTAIN DISCLAIMERS (S. 1983); AND THE ESTATE TAX VALUATION OF CERTAIN MINERAL PROPERTY

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

OF THE

SENATE COMMITTEE ON FINANCE

ON MAY 27, 1982

PREPARED BY THE STAFF OF THE

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INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on May 27, 1982, regarding estate and gift taxes.

There are two bills and one other matter scheduled for the hearing: S. 2479 (Senators Symms, Bentsen, Boren, Grassley, et. al.), relating to the installment payment of estate tax attibutable to certain interests in closely held businesses; S. 1983 (Senators Symms and Wallop), relating to the tax treatment of certain disclaimers; and the estate tax valuation of certain mineral property.

The first part of the pamphlet is a summary of the bills and the other matter. This is followed by a more detailed description of the bills, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects. This is then followed by a description of the other estate tax matter, including an explanation of present law.

I. SUMMARY

1. S. 2479—Senators Symms, Bentsen, Boren, Grassley, Helms, Jepsen, Johnston, Mathias, Mattingly, McClure Nunn, and Zorinsky

"Section 6166 Technical Revision Act of 1982"

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satisfied and the executor makes an election, payment of estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest for 4 years followed by from 2 to 10 payments of principal and interest) (sec. 6166). A special 4-percent interest rate is provided for tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)). Tax in excess of this amount ($345,800 of tax less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). The regular deficiency rate currently is 20 percent.

The bill would expand the types of interests in partnerships and corporations that are eligible for special treatment under the installment payment provision and would also permit the installment payment of estate tax attributable to certain combinations of assets that do not comprise an active business operation.

Under the bill, heirs would be permitted to dispose of interests in closely held businesses and to withdraw funds from the businesses for more purposes than is permitted under present law without losing the benefit of the 14-year extension of time for payment of tax.

The bill would also permit an estate tax deduction, in advance of payment, for interest that it is estimated will accrue on deferred tax during the 14-year extension period, and would provide a new interest rate applicable to the portion of deferred tax not subject to the special 4-percent rate of present law.

Finally, a new declaratory judgment provision would be enacted to provide Tax Court review of Internal Revenue Service determinations regarding eligibility for the installment payment provision and acceleration of unpaid tax. The decision of the Tax Court in these matters would be reviewable in the same manner as other decisions of that court.

2. S. 1983—Senators Symms and Wallop

Tax Treatment of Certain Disclaimers

A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. If a disclaimer is qualified for Federal tax purposes, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Under present law (applicable to transfers occurring after December 31, 1976), a disclaimer is effective for Federal transfer tax purposes if the requirements of Code section 2518 are satisfied. One of these requirements is that the disclaimer must be made not later than nine months after the date on which the transfer creating the interest occurs. In the case of a transfer of a remainder interest, the section provides that the remainder interest must be disclaimed within nine months of the transfer creating the interest.

Prior to the enactment of section 2518, however, there was no uniform Federal law regulating the manner or timing of disclaimers.

In regulations promulgated on November 14, 1958, the Internal Revenue Service took the position that, in order for a disclaimer to be effective for estate and gift tax purposes, the disclaimer had to be effective under local law and that it had to be made within a reasonable time after knowledge of the existence of the transfer. Thus, an individual wishing to disclaim a remainder interest was required to do so within a reasonable time after he obtained knowledge of the creation of the remainder interest rather than with a reasonable time after the death of the life tenant. The 1958 regulations applied to all transfers regardless of whether the transfer occurred prior to the promulgation of the regulations. Thus, an individual wishing to disclaim a remainder interest created prior to 1958 would have had to disclaimed the remainder interest within a reasonable time after that individual obtained knowledge of the creation of the remainder interest. On February 23, 1982, the Supreme Court upheld the Internal Revenue Service regulations with regard to the disclaimer of a remainder interest created prior to 1958. *Jewett* v. *Commissioner*, 50 U.S.L.W. 4215 (1982).

The bill would permit individuals possessing interests created by transfers prior to November 15, 1958, to disclaim those interests within (a) nine months after the date of enactment of the bill, or (b) nine months of the first day the disclaimant had knowledge of the disclaimed interest (which knowledge must be established by clear and convincing evidence), but in no event later than December 31, 1991.

3. Estate Tax Valuation of Certain Mineral Property

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use.

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. However, in all cases, it is presumed that land would change hands between a willing buyer and a willing seller based on the "highest and best use" to which that land could be put, rather than the actual use of the land at the time it is transferred.

Under present law, there are no special provisions regarding the valuation of mineral interests. However, to properly value real property at its highest and best use, the value of any underlying mineral interests must be considered, whether or not those mineral interests are presently being exploited. The issue is whether it is appropriate to determine the fair market value of real property by including the potential value of any undeveloped mineral rights.

II. DESCRIPTION OF THE BILLS AND OTHER ESTATE TAX MATTERS

1. S. 2479—Senators Symms, Bentsen, Boren, Grassley, Helms, Jepsen, Johnston, Mathias, Mattingly, McClure, Nunn, and Zorinsky

"Section 6166 Technical Revision Act of 1982"

Present Law

Overview

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satisfied and the executor makes an election,[1] payment of estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest) (sec. 6166).[2] A special 4-percent interest rate is provided for tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)).[3] Tax in excess of this amount ($345,800 currently is less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). The regular deficiency rate currently is 20 percent.

Qualification requirements

To qualify for the installment payment provision, at least 35 percent of the value of the decedent's adjusted gross estate must consist of the value (net of business indebtedness) of an interest in a closely

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[1] The election must be made within 9 months after the decedent's death (15 months if an extension of time to file the decedent's estate tax return is granted) (sec. 6166(d)). If a deficiency is later assessed, the deficiency is prorated among the installment payments to the extent that it would have been eligible for extended payment had the amount been shown on the estate tax return and if the deficiency was not due to negligence or intentional disregard of rules and regulations (sec. 6166(e)). Additionally, a special election is available to pay deficiency amounts in installments where (1) no installment payment election was initially made, (2) the estate, after examination, meets all requirements of the provision, and (3) the deficiency was not due to negligence or intentional disregard of rules and regulations (sec. 6166(h)).

[2] Because eligibility for the installment payment provision relates to the time of payment rather than the amount of tax, the decision of the Internal Revenue Service as to an estate's eligibility or as to acceleration of unpaid tax is not subject to judicial review.

[3] While the installment payment provision is generally explained as deferring estate tax attributable to closely held business property, that is not always true. The estate may extend payment of a percentage of its tax equal to the percentage of the adjusted gross estate which the business property comprises. This extension is available even if the inclusion of the business property does not result in any additional estate tax— as, for example, where it passes tax-free to a surviving spouse pursuant to the marital deduction.

held business. Under section 6166, all proprietorships owned by the decedent qualify as an interest in a closely held business. In addition, an interest in a closely held business includes interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied. An interest of a partner in a partnership carrying on a trade or business qualifies if—

(a) 20 percent or more of the value of the total capital interest in the partnership is included in the value of the decedent's gross estate ("percentage test"); or

(b) the partnership has 15 or fewer partners ("numerical test").

Stock in a corporation carrying on a trade or business qualifies if—

(a) 20 percent or more in value of the voting stock in the corporation is included in the value of the decedent's gross estate ("percentage test"); or

(b) the corporation has 15 or fewer shareholders ("numerical test").[4]

Attribution rules

Present law contains rules under which property owned by certain other persons is treated as owned by the decedent for purposes of determining whether the decedent's interest was an interest in a closely held business ("attribution rules"). These attribution rules are of two types—automatic and elective. Under these attribution rules, stock and partnership interests held by a husband and wife as community property or as joint tenants, tenants by the entirety, or tenants in common, are treated as owned by the decedent in determining the number of shareholders or partners a corporation or a partnership has. Additionally, all stock and partnership interests owned by members of the decedent's family[5] are treated as owned by the decedent. To prevent the use of trusts, corporations, and partnerships to avoid the numerical qualification tests for corporations and partnerships, the installment payment provision provides that property owned directly or indirectly by a corporation, partnership, estate, or trust is treated as owned proportionately by the owners of the entity.

The elective attribution rules permit an executor to elect to treat capital interests in partnerships and non-readily-tradable stock[6] owned by members of the decedent's family as owned by the decedent to determine whether the decedent owned 20 percent or more of voting stock or partnership capital in the closely held business (i.e., satisfied the percentage tests). If the elective attribution rules are used to qualify a business interest for the installment payment provision, the estate is not entitled to the special 4-percent interest rate or the initial 5-year deferral period for principal.

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[4] In the case of proprietorships, Treasury regulations provide that only assets actually used in the business are considered for purposes of the "35 percent of adjusted gross estate" test. In the case of partnerships and corporations, on the other hand, all partnership and corporate assets are considered even where some of the assets are not actually used in the business operation (Treas. Reg. § 20.6166A-2(c)).

[5] Family members include an individual's brothers and sisters, spouse, ancestors, and lineal descendants (sec. 267(c)(4)).

[6] Non-readily-tradable stock is stock for which there was no market on a stock exchange or over-the-counter market at the time of the decedent's death.

Aggregation rules

Present law also permits "aggregation" of interests in multiple closely held businesses to qualify an estate for the installment payment provision if 20 percent or more of the total value of each aggregated business is included in the value of the decedent's gross estate. Under the aggregation rules, the value of property owned by a surviving spouse with the decedent as community property, joint tenants, tenants by the entirety, or tenants in common is treated as owned by the decedent.

Definition of trade or business

Under present law, the installment payment election is available only for interests in active trades or businesses as opposed to passive investment assets. The Congressional intent that this provision not apply to all businesses or investment assets is illustrated by the Report of the Committee on Ways and Means on the Small Business Tax Revision Act of 1958 (H. Rept. No. 2198),[7] where the committee stated,

> The bill is to aid and encourage small business. It is not, however, an attempt to settle all of the small-businesses problems, even in the area of Federal taxation.
>
> * * *
>
> The . . . goal of the bill is to prevent the breakup of small businesses once they are established, and to prevent their consolidation into larger businesses. To aid in this respect your committee has provided up to 10 years for payment of estate taxes where investments are in a closely held business. This should make it unnecessary to sell a decedent's business in order to finance his estate tax.

The determination of whether an interest in an active trade or business is present is factual and must be made on an case-by-case basis. In interpreting the legislative history of the provision, the Internal Revenue Service takes the position that a passive holding company is not carrying on a trade or business. Further, the Service takes the position that the holding company is not pierced to determine whether any subsidiary owned in part or in whole by it is carrying on a trade or business. Likewise, the Service takes the position that assets passively leased to a separate active business, in which the decedent also owns an interest, do not constitute a trade or business for purposes of the installment payment provision.

The most detailed guidelines on what constitutes a trade or business under the installment payment provision are found in three 1975 revenue rulings—Rev. Rul. 75–365, 1975–2 C.B. 471; Rev. Rul. 75–366, 1975–2 C.B. 472; and Rev. Rul. 75–367, 1975–2 C.B. 472—issued under former section 6166A.[8]

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[7] The Small Business Tax Revision Act was enacted as Title II of the Technical Amendments Act of 1958 (P.L. 85–866, approved September 2, 1958). That Act included the predecessor provision to the present installment payment provision.

[8] Section 6166A, designated section 6166 before 1977, provided for payment of estate tax attributable to interests in closely held businesses in from 2 to 10 annual installments. Section 6166A was repealed by the Economic Recovery Tax Act of 1981, effective for estates of individuals dying after December 31, 1981.

In Rev. Rul. 75–365, *supra*, the IRS ruled that rental commercial property, rental farm property, and notes receivable did not constitute a trade or business within the meaning of the installment payment provision. The Service stated that the determination of what constitutes a trade or business is not made merely by reference to a broad definition of business or by reference to case law under section 162. It noted that——

> Although the management of real property by the owner may, for some purposes, be considered the conduct of business in the case of a sole proprietorship [the installment payment provision applies] only with respect to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets.
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> * * *
>
> It follows that the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute. (*Id.*).

Rev. Rul. 75–366, *supra*, applied the trade or business testin a farming situation. In that case, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The decedent was held to be in the business of farming under these facts, the Service saying——

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit. either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.
>
> Accordingly, the farm real estate included in the decedent's estate qualifies . . . as an interest in a closely held business. (*Id.*).

Finally, Rev. Rul. 75–367, *supra*, held that a subchapter S corporation engaged in home construction was a trade or business within the meaning of the installment payment provision, but ownership and management of eight rental homes was not. The ruling also held that a proprietorship that developed land and sold new homes built by the construction company was a trade or business. In that ruling, the Service construed Congressional intent in enacting the installment payment provision as being to permit——

> * * * [T]he deferral of the payment of the Federal estate tax where, in order to pay the tax, it would be necessary to sell assets used in a going business and thus disrupt or destroy the business enterprise. Thus [provision] was not intended to protect continued management of income producing properties or to permit deferral of the tax merely because the payment of the tax might make necessary the sale of income-producing assets, except where

they formed a part of an active enterprise producing business income rather than income solely from the ownership of property. (*Id.* at 473).

When interests in oil and gas ventures constitute a trade or business within the meaning of the installment payment provision was the subject of a separate ruling by the IRS. In Rev. Rul. 61–55, 1961–1 C.B. 713, the Service held that the ownership, exploration, development, and operation of oil and gas properties is a trade or business, but the mere ownership of royalty interests is not.[9]

Acceleration of unpaid tax

The right to defer payment of estate tax is terminated upon the occurrence of certain events during the 14-year extension period. If such a termination occurs, all unpaid installments of tax and accrued interest are accelerated and are payable on notice and demand from the IRS.

Disposition of interest and withdrawal of funds from the business

If the persons receiving property from the decedent whose estate elects the installment payment provision make cumulative dispositions of the interest in the business and withdrawals from the business totaling 50 percent or more of the value of the decedent's interests, all unpaid installments and interest are accelerated. Generally, mere changes in form of ownership are not treated as dispositions.[10] Additionally, ERTA provided a new exception which excludes dispositions by reason of death of the heir (or a subsequent transferee) from this rule. However, this exception applies only if the property is transferred to a member of the deceased heir's (or subsequent transferee's) family.

A further exception is provided for withdrawals from a corporation pursuant to a redemption under section 303, but only if all proceeds of the redemption are used to pay Federal estate taxes no later than the due date of the first installment becoming due after the redemption (or one year after the redemption, if earlier).[11]

Undistributed income of estate

If an estate has undistributed net income in any year, the income must be applied against unpaid installments by the due date of the estate's income tax return, or the unpaid tax and accrued interest is accelerated.

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[9] Under present income tax law, co-ownership of working interests in an oil and gas lease is treated as a partnership; however, if the co-owners elect, they will be treated as proprietors rather than partners (sec. 761(a)). This "election-out" of partnership treatment is not available for estate tax purposes.

[10] Under present law, a corporate reorganization which is not an income taxable event under sec. 368(a)(1)(D), (E), or (F) is not treated as a disposition of an interest in the business for purposes of accelerating unpaid installments of tax. Likewise, certain dispositions of stock in controlled corporations (sec. 355) are not treated as dispositions.

[11] Sec. 303 provides special tax treatment for redemptions of corporate stock to the extent that the redemption proceeds to a shareholder do not exceed the total death taxes (including, but not limited to, Federal estate taxes) imposed by reason of the decedent shareholder's death and the amount of funeral and administration expenses allowable as an estate tax deduction to the estate.

Late payments of principal or interest

In general, if an estate fails to make any payment of principal or interest by its due date, all unpaid amounts are accelerated. A limited exception is provided for late payments received within six months after the due date. However, such late payments are not eligible for the special 4-percent interest rate, and the estate must pay a special penalty of 5 percent of the payment for each month (or part thereof) that the payment is late.

Deductibility of interest

Interest accrued as a result of extending payment of tax under the installment payment provision is deductible by the estate. The interest may be claimed as an administration expense in determining estate tax (sec. 2053) or may be claimed as an income tax deduction. The executor must elect the manner in which the deduction is to be claimed (sec. 642(g)).

In general, interest is only deductible for estate tax purposes when it is actually paid. The IRS holds that this general rule applies also to interest on tax payment of which is extended under the installment payment provision (Rev. Rul. 80–250, 1980–2 C.B. 278). Therefore, if an estate elects to claim such interest as an estate tax deduction, an amended estate tax return must be filed each year as the interest is paid. The interest deduction reduces the decedent's estate tax, and this reduction is reflected in reductions in the unpaid installments (Rev. Proc. 81–27, 1981–27 I.R.B. 21).

Other extensions of time to pay estate tax

If an estate is not eligible to defer estate tax under the installment payment provision, payment of the tax may be extended under the general estate tax extension of time to pay. Present law permits an extension of time to pay tax for up to 10 years upon a showing of reasonable cause. This extension is granted for a maximum period of one year at a time and can be renewed annually (as long as the reasonable cause continues to exist). One situation in which reasonable cause is present is where an estate does not have sufficient funds to pay the tax when otherwise due without borrowing at a rate of interest higher than that generally available (Treas. Reg. § 20.6161–1(a)).

Issues

The principal issue is whether the installment payment provision should be expanded to allow estate tax attributable to additional types of business investments.

A second issue is whether the circumstances under which estate tax deferred under the installment payment provision is accelerated should be liberalized.

A third issue is whether the normal rule that interest is deductible for estate tax purposes only when paid should be changed in the case of interest accruing on estate tax deferred under this provision so as to permit a deduction for the full amount of interest which might be paid when the estate tax return is filed.

A fourth issue is whether an interest rate, other than the regular deficiency rate, should apply to extended amounts of tax in excess of amounts subject to the special 4-percent rate of present law.

A final issue is whether decisions of the Internal Revenue Service as to qualification of an estate for the installment payment provision or acceleration of unpaid tax should be subject to judicial review even though the amount is not in dispute.

Explanation of the Bill

Overview

The bill would expand the types of assets that are eligible for special treatment under the installment payment provision as an interest in a closely held business in several ways, would liberalize the rules under which unpaid installments of tax and interest are accelerated, would provide a new interest rate on deferred tax and new rules on the deductibility of that interest, and would provide for judicial review of IRS determinations under the provision.

Qualification requirements

General rules

The bill would expand the types of business interests that qualify for the installment payment provision in numerous ways. The bill would increase the number of partners or shareholders a closely held business can have under the numerical tests for qualifying interests in a partnership or corporation as an interest in a closely held business from 15 to 35. Thus, under the bill, if a partnership or corporation had 35 or fewer partners or shareholders, the numerical test would be satisfied.

The bill would count interests in partnership profits under the percentage test for qualifying interests in a partnership as an interest in a closely held business. Only interests in partnership capital are counted under present law. Thus, under the amendment, if the decedent owned capital or profits interests in a partnership, or a combination of the two, totaling 20 percent or more of the value of the business, the percentage test would be satisfied.

The bill would count nonvoting stock under the percentage test for qualifying an interest in a corporation as an interest in a closely held business. Only voting stock is counted under present law. Thus, under the bill, if the decedent owned voting or nonvoting stock, or a combination of the two, totaling 20 percent or more of the value of the business, the percentage test for corporations would be satisfied.

The bill would treat certain notes and other evidences of indebtedness as interests in closely held businesses (in addition to stock and partnership interests which are considered under present law) in determining whether the decedent owned an interest in a closely held business. This type of interest would be considered in addition to, or in combination with, corporate stock or interests in partnership profits and capital. Only debt interests acquired in exchange for stock and partnership interests owned by the decedent or for money which the decedent loaned the business more than one year before his death, would be considered. Thus, under the bill, the fact that the decedent withdrew from the business by selling the decedent's interest pursuant to a "buy-out" agreement with another owner who planned to continue the business after withdrawal from the business of the decedent would not preclude availability of the installment payment provision for the decedent's estate.

The bill would eliminate the present law difference in treatment of certain nonbusiness assets owned by partnerships and corporations as compared to those assets owned by individuals carrying on businesses as proprietorships. The bill would apply the present rule for proprietorships to all businesses where assets were contributed to the business by or on behalf of the decedent and were not used in the conduct of the business throughout the one-year period ending on the date of the decedent's death. Therefore, under the bill, these nonbusiness assets would not be included in determining whether the decedent's interest in the business satisfied the requirement that 20 percent or more of the total interests in a partnership or 20 percent or more of the stock in a corporation (i.e., the percentage tests) be included in the decedent's gross estate.

Attribution rules

The bill would combine the automatic and elective attribution rules of present law and would eliminate the penalties that apply under the elective attribution rules. The new attribution rules would apply to both the numerical tests and percentage tests for determining whether partnerships and corporations are closely held businesses. In addition, the definition of family member (i.e., persons whose stock or partnership interests are treated as owned by the decedent) would be expanded to include spouses of brothers, sisters, and lineal descendants of the decedent as well as estates of family members. The broader attribution rules would normally increase the value of the business interest treated as owned by the decedent for purposes of determining whether his estate qualified under the installment payment provision.

Aggregation rules

The bill would expand the present law rules under which interests in multiple businesses are aggregated to qualify for the installment payment provision. Under the bill, interests which satisfy either the numerical test or the percentage test for determining whether the business is a closely held business could be aggregated to meet the requirement that an interest in a closely held business equal at least 35 percent of the decedent's adjusted gross estate. This aggregation would only be permitted if the value of each such business comprised a least 5 percent of the value of the decedent's adjusted gross estate. Thus, an estate could aggregate interests in a maximum of 20 businesses to qualify for the installment payment provision.

Definition of trade or business

The bill would expand the types of assets that, in combination, constitute a trade or business under the installment payment provision to include interests (stock, partnership interests, and indebtedness) in passive holding companies to the extent that the holding company assets represent interests in active businesses which would meet the requirements of the provision if owned directly.

The bill would also expand the availability of the installment payment provision for estates owning interests in oil and gas ventures. Under the bill, if an income tax election to treat co-owners of an oil and gas lease as proprietors were in effect at the decedent's death (under sec. 761(a)), the co-owners would be treated as proprietors for estate tax purposes as well.

Two other exceptions to the active business requirement would be enacted by the bill. First, the bill would treat royalty interests in oil and gas ventures as interests in closely held businesses regardless of whether these interests are essentially passive investment assets. Second, the bill would treat assets owned by the decedent that are passively leased to a closely held business in which the decedent was a partner or shareholder as interests in such a business.

Expansion of acceleration exceptions

The bill would expand the present law situations in which an interest in a closely held business can be disposed of and in which property can be withdrawn from the business during the extended payment period without accelerating the payment of deferred estate tax. These expanded exceptions would apply to estates of individuals who died before 1982 which elected the benefits of former section 6166A as well as to all estate electing the present installment payment provision.

Dispositions and withdrawals to pay death taxes and estate expenses

The present rule under which certain redemptions of stock from a corporation solely to pay Federal estate taxes are not treated as dispositions or withdrawals under the acceleration rules would be amended to extend this rule to any disposition or withdrawal of funds of an interest in a closely held business (whether or not by means of a redemption under sec. 303) to the extent that the proceeds are used to pay any death taxes resulting from the decedent's death (including, but not limited to, Federal estate taxes) and also funeral and administration expenses (including interest on the deferred tax) allowable to the estate as an estate tax deduction. Thus, the exception would apply to proprietorships and partnerships as well as corporations and would permit interests in the business to be sold to third parties as well as redeemed by the business entity. In addition, the bill would delay the date by which the tax would have to be paid following the disposition in the case of dispositions occurring during the first 5 years of the extended payment period. In such cases, payment of the taxes or expenses would not have to be made until the due date of the first installment of tax. Therefore, estates could dispose of stock in a closely held business up to 5 years before the proceeds of the disposition were used for payment of death taxes or funeral or administration expenses.

Reorganizations

The bill would expand the present exception to the acceleration rules for certain corporate reorganizations and stock distributions to include additional types of reorganizations (under sec. 368(a)(1)) and also tax-free exchanges of common stock for preferred stock in the same corporation (under sec. 1036).

No acceleration on subsequent death

The bill would expand the present exception to the acceleration rules for dispositions to a family member by reason of death of the heir (or subsequent transferee) receiving the decedent's closely held business property, to permit such transfers without acceleration of unpaid tax whether or not the transferee is a family member.

No acceleration in case of certain buy-outs

The bill would enact a new exception to the acceleration rules for certain dispositions of interests in and withdrawals of funds from closely held partnerships and corporations if a note, rather than cash, is received. Under the new exception, the heir receiving the decedent's closely held business interest would be treated as disposing of the interest only to the extent that the value of the surrendered stock or partnership interest exceeded the face value of the note. The exception would only be available for exchanges where the note is (1) given by the corporation or partnership, or (2) where the note is given by another shareholder, partner, or an employee, and the purchaser had been a shareholder, partner, or employee of the business at all times during the one-year before the exchange. If the purchaser were a shareholder or employee, the corporation or partnership would be required to guarantee the note. The bill would include special rules to accelerate unpaid tax if the note became readily tradable, were surrendered, or if 50 percent or more of the value of the business were acquired by a corporation whose stock was readily tradable.[12]

Involuntary conversions

The bill would provide that, in the case of an involuntary conversion, an interest in closely held business property is not considered to be disposed of to the extent that qualified replacement property is acquired.

Like-kind exchange

The bill would provide that, in the case of a like-kind exchange, an interest in closely held business property is not considered to be disposed of to the extent that the exchange is not taxable for income tax purposes (under sec. 1031).

Interest on installment payments

Under the bill, the special 4-percent interest rate would continue to apply the first $345,800 (minus the amount of the decedent's unified credit) of estate tax extended under the installment payment provision. However, the rate on extended amounts in excess of the amount subject to the 4-percent interest rate would not accrue interest at the rate otherwise applicable to deficiencies (currently 20 percent). Under the bill, extended amounts in excess of this 4-percent portion would accrue interest at a rate equal to the average yield to maturity, of 14-year United States obligations, during the month of December preceding the year of the decedents' death.[13]

The bill would also change the manner in which the interest on installment payments is deducted for estate tax purposes. Under the bill, the full amount of interest anticipated to be paid over the 14-year extended payment period would be deductible when the decedent's estate tax return was filed (even though the interest was not

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[12] Readily tradable stock or notes would be stock or notes which there was a market in any stock exchange or in any over-the-counter market.

[13] At the present time, the Treasury Department has no obligations maturing in the month of December. Long-term obligations are normally issued in January with maturity dates of February 15, May 15, August 15, or November 15.

paid at that time). The amount of this deduction would not be discounted to reflect the fact that the interest was not presently payable. If the installment payment election were terminated before expiration of the 14-year extension period, the estate would recompute the deduction for interest, and its estate tax, at the time of the termination.

Declaratory judgment relating to installment payment provision

The bill would provide a precedure for obtaining a declaratory judgment with respect to—

(1) an estate's eligibility for extension of tax under the installment payment provision, or

(2) whether there is an acceleration of unpaid tax.

The declaratory judgment provision would only be available when there is an actual controversy; therefore, no declaratory judgment would be available before the decedent's death (with respect to eligibility for the extension) or before a transaction causing a potential acceleration of unpaid tax.

Jurisdiction to issue the declaratory judgment would be in the Tax Court, and the decision of the Tax Court would be reviewable in the same manner as other decisions. Collection of tax would be stayed until after a decision was rendered by the Tax Court, but the executor (or heir in the case of a dispute over acceleration of unpaid tax) would be required to pay the tax or post bond before appealing from the Tax Court. The bill would also permit the courts to impose penalties in the case of actions brought primarily for delay and where it was determined that the estate was not eligible for the extension provided by the installment payment provision or that the tax was properly accelerated.

Effective Dates

The provisions of the bill would apply generally to estates of individuals dying after December 31, 1981.

The provisions of the bill relating to acceleration of unpaid tax would apply to dispositions and withdrawals after December 31, 1981.

The provisions of the bill amending the rate of interest charged on installment payments and the estate tax deductibility thereof would apply to estates of individuals dying after December 31, 1981, and also—

(1) in the case of the rate of interest charged on installment payments, to tax outstanding on January 1, 1982, for an estate for which a timely election was made under either section 6166 or section 6166A, if the executor elects to have the amendment apply; and

(2) in the case of the rules on the estate tax deduction of interest on installment payments, to tax estimated to accrue after December 31, 1981, for an estate for which a timely election was made under either section 6166 or section 6166A, if the executor elects to have the amendment apply.

Elections to have these amendments apply could be made even though the estate had elected previously to claim the interest as an income tax deduction.

The provisions of the bill authorizing penalties in the case of certain declaratory judgment proceedings, and appeals from Tax Court decisions, would apply after the date of enactment.

Revenue Effect

It is estimated that this bill would reduce Federal budget receipts by less than $50 million in fiscal year 1982, by $476 million in fiscal 1983, by $514 million in 1984, by $555 million in 1985 and by $599 million in 1986.

2. S. 1983—Senators Symms and Wallop

Tax Treatment of Certain Disclaimers

Present Law

In general, a disclaimer is a refusal to accept the ownership of property or rights with respect to property. If a qualified disclaimer is made, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Prior to the enactment of section 2518 in 1976, there were no uniform Federal disclaimer rules. Before the promulgation of regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal tax consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, the Treasury Department issued regulations (T.D. 6334) which required that a disclaimer (1) be effective under local law and (2) notwithstanding the timeliness of the disclaimer under local law, be made "within a reasonable time after knowledge of the existence of the transfer." In litigating this issue, they interpreted these regulations to require that a disclaimer be made within a reasonable time after the creation of the interest, rather than the time at which the interest vested, or became possessory. Thus, for example, where property is transferred to X for life, remainder to Y, both X and Y were required to disclaim within a reasonable time of the original transfer, although Y could not take possession of the property until X's death.

These regulations also applied to interests created by transfers made prior to November 15, 1958. Thus, under the regulations, a disclaimer of an interest created by a transfer made prior to November 15, 1958, would be qualified for Federal tax purposes only if it were made within a reasonable time after the original transfer creating the interest.

This dispute as to the timing of a qualified disclaimer generated considerable litigation, with conflicting results. The Tax Court upheld the Treasury position in a series of cases including *Jewett* v. *Commissioner* 70 T.C. 430 (1978), *Estate of Halbach* v. *Commissioner* 71 T.C. 141 (1978) and *Cottrell* v. *Commissioner* 72 T.C. 489 (1979). However, the Circuit Courts were divided on the issue. The Eighth Circuit rejected Treasury's position, concluding that State law determines the validity of a disclaimer in *Keinath* v. *Commissioner* 480 F.2d 57 (1973) and *Cottrell* v. *Commissioner*, 628 F.2d 1127 (1980). However, the Ninth Circuit upheld the decision in *Jewett* v. *Commissioner* in 1980 (638 F.2d 93) and the Supreme Court granted Certiorari.

On February 23, 1982, the Supreme Court resolved the controversy in *Jewett* v. *Commissioner*[1] by upholding the Treasury position. Noting that the Treasury interpretation is entitled to respect because it has been consistently applied over the years, the Court concluded that the relevant "transfer" occurs when the interest is created and not at such later time as the interest vests or becomes possessory.

In the Tax Reform Act of 1976, Congress adopted a set of uniform rules to govern disclaimers of property interests transferred before December 31, 1976 (Sec. 2518). Under that section, a disclaimer generally is effective for Federal estate and gift tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and meets four other conditions. First, the refusal must be in writing. Second, the written refusal generally must be received by the person transferring the interest, or the transferor's legal representative, no later than nine months after the transfer creating the interest.[2] Third, the disclaiming person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer or to the decedent's surviving spouse as a result of the refusal to accept the interest.[3]

Issue

The issue is whether a disclaimer by an individual of an interest created before November 15, 1958, should be effective for estate and gift tax purposes where the disclaimer is made subsequent to a reasonable period after that individual obtained knowledge of the creation of the interest.

Explanation of the Bill

Under the bill, a disclaimer of an interest created by a transfer made before November 15, 1958 would be treated as a qualified disclaimer if it meets the requirements of section 2518 and is made (1) within nine months of enactment, or (2) within nine months of the first day the disclaimant had knowledge of such interest (which knowledge must be established by clear and convincing evidence). However, in no event would a disclaimer made after December 31, 1991 be treated as a qualified disclaimer.

Effective Date

The bill would apply to disclaimers made with respect to transfers made before November 15, 1958.

Revenue Effect

It is estimated that this bill would reduce budget receipts by less than $5 million annually.

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[1] 82-1 USTC ¶13, 453; 50 U.S.L.W. 4215; 49 AFTR 2d 148,104.

[2] However, the period for making the disclaimer is not to expire until nine months after the date on which the person making the disclaimer has attained age 21.

[3] In addition, with respect to interests created after December 31, 1981, certain transfers to the person or persons who would have otherwise received the property if an effective disclaimer had been made under local law, may be treated as qualified disclaimers, provided the transfer is timely made and the transferor has not accepted the interest or any of its benefits.

3. Estate Tax Valuation of Certain Mineral Property

Present Law

Overview

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use.

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. One of the most important factors used in determining fair market value is the highest and best use to which the property can be put.

Where the fair market value of real property is the subject of dispute, there are several valuation techniques which the courts tend to accept. These methods include the income-capitalization technique, the reproduction-cost minus depreciation technique, and the comparative sales technique. Courts will generally use one of these methods, or a combination of these methods, in determining fair market value.

However, in all cases, it is presumed that land would change hands between a willing buyer and a willing seller based on the "highest and best use" to which that land could be put, rather than the actual use of the land at the time it is transferred.

Mineral interests

Under present law, there are no special provisions regarding the valuation of mineral interests. However, to properly value real property at its highest and best use, the value of any underlying mineral interests must be considered whether or not those mineral interests are presently being exploited.

If the mineral rights are being exploited, their value—in the form of a separate royalty interest—may be readily ascertainable through the expert testimony of geologists or mining engineers. Generally, such value would be based on the facts and circumstances of the particular property. Factors to be considered include: the annual income from the royalty, the amounts of any bonus payments or delay rentals received, the amount of minerals still available for exploitation and the quality of those minerals, changing market conditions affecting pricing, contractual limitations imposed on the terms and conditions of the royalty, and any government or industrial restrictions on development. The total value of the real property would include the value of these mineral rights.

If the mineral interests are not presently being exploited, valuation becomes more difficult because any determination of the property's fair market value must be made without regard to actual royalty income or development experience. Expert testimony is needed to analyze

known geologic data and determine the extent and quality of any underlying mineral interest. The valuation of such interest may then be determined by analyzing comparable properties, which are presently being developed.

The determination of whether property is comparable must be made on a case-by-case basis, with no single factor being conclusive. Different parcels of real property need not be exactly alike to be comparable, however. Comparability requires only that the different parcels contain similar mineral interests.

If comparable properties are not available, the property would generally be valued through an income capitalization technique, which uses projected net income to determine the value of the underlying property. The accuracy of those projections depends, in large part, on the extent and quality of available geologic data. Where such data is incomplete, projected earnings are often discounted to offset a high degree of speculation and insure that the value of the property bears a reasonable relationship to its earning capacity.

Issues

The issues are whether it is appropriate to determine the value of real property by including undeveloped mineral rights in computing its "highest and best use" or whether it would be appropriate to exclude such value until or unless the mineral rights actually are exploited.

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